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MONEY LAUNDERING

“Proceeds” Means “Profits” in the Federal Money Laundering Statute

In *United States v. Santos*, 128 S.Ct. 2020 (2008), a case involving an illegal gambling business under 18 U.S.C. § 1955, the Supreme Court held, in a narrow 5-4 decision, that the term “proceeds” as used in the federal money-laundering statute, 18 U.S.C. § 1956(a)(1), means “profits,” not “receipts.” The five votes in favor of the judgment consisted of a four-justice plurality and a concurring opinion written by Justice Stevens, which disagreed with the plurality’s rationale but agreed with the holding.

Efrain Santos (“Santos”) operated an illegal lottery from the 1970s until 1994. He employed a number of “runners,” who gathered bets from gamblers and delivered them to “collectors.” The collectors, including Santos’ codefendant Benedicto Diaz (“Diaz”), then delivered the money to Santos, who used some of it to pay the collectors’ salaries and some to pay the winners.

At trial, Santos was convicted of conspiracy to launder money and money laundering, among other charges, and Diaz pleaded guilty to conspiracy to launder money. The Seventh Circuit affirmed their convictions and sentences.

Santos and Diaz subsequently moved to vacate under 28 U.S.C. § 2255. Citing *United States v. Scialabba*, 282 F.3d 475 (7th Cir. 2002), which held that the term “proceeds” in the money-laundering statute means “profits,” the district court vacated the money-laundering convictions. The Seventh Circuit affirmed.

The Supreme Court granted certiorari and affirmed the Seventh Circuit’s decision. The plurality found that the money-laundering statute is ambiguous because it fails to define the term “proceeds.” Invoking the rule of lenity, the plurality reasoned that the term “proceeds” in 18 U.S.C. § 1956 should be interpreted to mean “profits,” because such an interpretation would be more “defendant-friendly.” Further, the plurality argued that, if “proceeds” were interpreted to mean “receipts,” a “merger problem” would result, because most defendants found guilty of operating

illegal lotteries would also be guilty of money laundering. Finding that none of the payments at issue involved the lottery’s profits, the plurality concluded the convictions should be vacated.

In his concurring opinion, Justice Stevens proposed that the ambiguity of the money-laundering statute be resolved on a case-by-case basis, depending on the nature of the underlying illegal activity. In this particular case, Stevens agreed that “proceeds” should be interpreted to mean “profits,” because the legislative history was silent on the issue and because a merger problem would otherwise result.

Concealment of Funds Transported across U.S. Border Not Sufficient to Prove International Money Laundering

In *Cuellar v. United States*, 128 S.Ct. 1994 (2008), the Supreme Court held that the government cannot establish a violation of the international money laundering statute, 18 U.S.C. § 1956(a)(2)(B)(i), solely by demonstrating that the defendant concealed the funds while transporting them out of the United States.

On July 14, 2004, Humberto Fidel Regalado Cuellar (“Cuellar”) was stopped in Texas while driving south toward the Mexican border. A drug detection dog alerted officers to the rear area of the car, where approximately \$81,000 in cash was found in a secret compartment under the rear floorboard. Cuellar was charged with and convicted of international money laundering in violation of 18 U.S.C. § 1956(a)(2)(B)(i). The Fifth Circuit reversed his conviction, but, in a rehearing *en banc*, the conviction was affirmed.

The Supreme Court granted certiorari and vacated Cuellar’s conviction. The Court rejected Cuellar’s argument that, in order to prove the transportation of the funds was “designed ... to conceal,” as required by the statute, the government had to prove he had attempted to create the appearance of legitimate wealth. The Court noted that the international money laundering statute reaches concealment not only of the nature or source of illegal funds, but also of their location, ownership or control. The Court reasoned that conduct such as smuggling cash into Mexico in order to hide it by burying

it in the desert might be covered by the statute even though such conduct would not necessarily make the funds appear legitimate.

The Court then turned to the question of whether the evidence that Cuellar concealed the money during transport was sufficient to sustain his conviction. The Court interpreted the international money laundering statute as requiring proof that the purpose (and not just the manner) of the transportation was concealment. Here, the government's evidence demonstrated that the purpose of the transportation was to compensate the leaders of a drug operation, not to conceal the funds. Therefore, the Court concluded that the evidence was insufficient to sustain Cuellar's conviction.

The Court rejected the Fifth Circuit's view that evidence of the cash economy in the Mexican border town to which Cuellar was headed and of the wide acceptance of U.S. currency there indicated Cuellar was transporting the money to Mexico for the purpose of concealing it. The Court explained that, even though this evidence suggested Cuellar's transportation of the funds would have had the *effect* of concealing the funds, there was no evidence that Cuellar knew about or intended the effect.

The Court concluded that the elements of § 1956(a)(2)(B)(i) cannot be satisfied solely by evidence that the defendant concealed the funds during their transport. Because the government's evidence showed only that Cuellar concealed the funds *en route* to Mexico, the Court held that his conviction could not stand, and it reversed the judgment of the Fifth Circuit.

D.C. Circuit Holds Deposits of Checks Payable to Straw Buyers Did Not Prove Intent to Conceal

In *United States v. Adefehinti*, 510 F.3d 319 (D.C. Cir. 2007), the D.C. Circuit vacated the money-laundering conviction of Bode, one of five defendants tried together for a fraudulent real estate scheme. The circuit court concluded that the evidence was insufficient to convict Bode of intending to conceal funds, an essential element of the money-laundering charge.

Bode and his co-defendants used bank loans to buy inexpensive properties, which they sold to each other for artificially high prices. The loans were obtained by submitting fraudulent loan applications using "straw buyers" with fabricated identities.

At trial, Bode was convicted of money laundering under 18 U.S.C. § 1956(a)(1)(B)(i), based on his role in allocating the proceeds from a fraudulent sale. Part of the sale proceeds were deposited into his bank account and the remainder into several other accounts, including the real estate company's account. Bode's co-defendant then wrote checks to another

co-defendant on the real estate company's account.

On appeal, the circuit court noted that the mere transfer of unlawfully obtained funds is not sufficient to prove the requisite intent to conceal: "The money laundering statute criminalizes behavior that masks the relationship between an individual and his illegally obtained proceeds; it has no application to the transparent division or deposit of those proceeds." 510 F.3d at 322. The court described a "spectrum" of cases from those involving multiple, complicated transfers of the funds that manifest an intent to conceal, to those involving either simple transactions or nothing more than the initial crime. After examining the facts in this case, the court concluded that the transactions at issue were of the latter sort: "All the transactions conspicuously lack the 'convoluted' character associated with money laundering." *Id.* at 324.

The court rejected the government's argument that the defendants' intent to conceal began with the deception inherent in making checks payable to "straw buyers." The court reasoned that "[h]aving carried out a fraud of which concealment was an integral part, defendants cannot be charged with the same concealment a second time, as if it were the sort of independent manipulation of the proceeds required for money laundering." *Id.* at 324 (internal citations omitted). Accordingly, the court reversed Bode's conviction for money laundering.

CORPORATE DIVERSIONS/CONSTRUCTIVE DISTRIBUTIONS

Supreme Court Holds No Showing of Intent Required to Claim Return-of-Capital Treatment for Corporate Diversion

In *Boulware v. United States*, 128 S.Ct. 1168 (2008), the Supreme Court held that a diverter of corporate funds facing charges of criminal tax evasion may claim return-of-capital treatment under 26 U.S.C. § 301 without producing evidence that either he or the corporation intended a return of capital when the diversion occurred.

Michael Boulware diverted millions of dollars from his closely-held corporation without reporting it on his personal income tax returns. He was charged with several counts of tax evasion and filing a false income tax return. In defense, Boulware proffered evidence that the corporation had no earnings and profits for the years at issue, and that therefore the diverted funds were nontaxable returns of capital, up to his basis in his stock. Relying on the Ninth Circuit's decision in *United States v. Miller*, 545 F.2d 1204 (1976), the government moved to bar the evidence on the grounds that a return-of-capital defense cannot be raised without a showing that the distribution was intended to be a return of capital. The district court granted the motion, and the Ninth

Circuit affirmed.

The Supreme Court vacated the Ninth Circuit's decision. The Court explained that the existence of a tax deficiency is an essential element of tax evasion under 26 U.S.C. § 7201 and noted that the deficiency determination in this case turned on 26 U.S.C. §§ 301 and 316(a). Because sections 301 and 316(a) do not have an intent requirement, the Court concluded that the existence of a deficiency depends "on facts wholly independent of intent: whether the corporation had earnings and profits, and the amount of the taxpayer's basis for his stock." 128 S.Ct. at 1177.

The Court added that willfulness, another element of criminal tax evasion, could be addressed without adding an intent requirement to the constructive distribution rules.

In the absence of factual findings with respect to stock ownership, the Court declined to address the government's argument that before any distribution may be treated as a return of capital, it must constitute a distribution to the shareholder "with respect to stock."

Further, the *Boulware* opinion did not reach the question of whether an unlawful diversion – for example, embezzlement or fraud – may ever be deemed a distribution with respect to stock.

Boulware has been remanded to the Ninth Circuit for further proceedings consistent with the Supreme Court's opinion.

SIXTH AMENDMENT

Eight-Year Delay in Informing Defendant of Indictment Violated Sixth Amendment

In *United States v. Mendoza*, No. 06-50447, 2008 WL 1970339 (9th Cir. May 8, 2008) (rehearing denied), the Ninth Circuit held that the eight-year delay between the indictment and the arrest of Paul Mendoza, who was living abroad, violated his Sixth Amendment right to a speedy trial.

In 1989 and 1990, Mendoza embezzled approximately \$285,000, which he failed to report on his tax returns. He was indicted in April 1996, at which time he was living in the Philippines. The government made no attempt to inform him of the indictment. He returned to the U.S. in June 2004 and was arrested in October 2004. After his arrest, Mendoza sought and received seven continuances of the trial date. At trial, he moved to dismiss the indictment on Sixth Amendment grounds. The motion was denied, and he was convicted of two counts of subscribing to a false income tax return under 26 U.S.C. § 7602(1).

On appeal, the Ninth Circuit agreed with Mendoza that his arrest violated his right to a speedy trial and reversed his conviction on that basis. Citing *Barker v. Wingo*, 407 U.S.

514, 530 (1972), the court weighed the following four factors in making its determination: (1) the length of the delay; (2) the reason for the delay; (3) the defendant's assertion of his right; and (4) prejudice to the defendant. With respect to the first two *Barker* factors, the court found that the ten years between the indictment and the trial created a presumption of prejudice and that, because the government had contact information for Mendoza, the delay resulted from the government's negligence. Because Mendoza asserted his right to a speedy trial after making several requests for continuances, the court found that the third factor did not weigh in favor of either party.

The court then examined whether the delay resulted in prejudice and found that this factor weighed in Mendoza's favor. The court cited *United States v. Shell*, 974 F.2d 1035 (9th Cir. 1992), a case that invoked the Supreme Court's opinion in *Doggett v. United States*, 505 U.S. 647 (1992) for the principle that, where the government's actions cause a long pre-trial delay, prejudice is presumed. On this basis, the court presumed Mendoza had suffered prejudice and concluded that his speedy-trial right had been violated.

In his concurrence, Circuit Judge Bybee agreed that *Doggett* left the Ninth Circuit with no choice but to overturn Mendoza's convictions, even though the facts suggested that Mendoza in reality had suffered no prejudice. He stated that the case demonstrated "how *Doggett* requires a presumption unsupported by the record."

EVIDENCE

Ninth Circuit Holds Expert Testimony Regarding Mental State Is Admissible

In *United States v. Cohen*, 510 F.3d 1114 (9th Cir. 2007), Lawrence Cohen appealed his conviction for aiding in the filing of a false tax return in violation of 26 U.S.C. § 7206(2). The Ninth Circuit reversed, on the ground that the district court had wrongfully excluded expert psychiatric testimony regarding Cohen's mental state.

Under the direction of his employer, Cohen had advised a number of individuals to file "zero returns" that reported no income or expenses. At trial, Cohen proffered the expert testimony of a psychiatrist, who had written a report diagnosing Cohen with a narcissistic personality disorder and concluding that he did not intend to violate the law. The report suggested that Cohen's disorder caused him to adhere to the irrational belief that filing zero returns was legal. The district court barred the testimony on the grounds that the psychiatrist failed to explain how the alleged mental disorder negated *mens rea* and instead merely explained or justified Cohen's conduct.

On appeal, the Ninth Circuit determined that the testimony was admissible under Federal Rule of Evidence 702 because it would have assisted the trier of fact. The court acknowledged that, given the conclusions contained in the report, some of the proffered testimony would likely have compelled the jury to conclude that Cohen lacked the requisite *mens rea* and would thus have violated FRE 704(b). Nonetheless, the court concluded that, rather than bar the testimony altogether, the district court should simply have sustained the government's objections to questions likely to elicit inadmissible evidence.

In addition to determining that the psychiatrist's testimony was admissible under FRE 702 and 704(b), the court disagreed with the government's alternative argument that the testimony should have been excluded under FRE 403, which provides that relevant evidence may be excluded if its probative value is substantially outweighed by the danger of confusing or misleading the jury. The court reasoned that the psychiatrist's testimony would have been highly probative with respect to Cohen's ability to form the requisite *mens rea* and was unlikely to confuse the jury so long as there was compliance with the rules of evidence.

Finally, the court concluded that the exclusion of the testimony was not harmless error because without the testimony Cohen had no way to explain the potential effect of his mental disorder on his ability to form the requisite *mens rea*. Therefore, the court reversed Cohen's conviction, vacated his sentence, and remanded for a new trial.

Fourth Circuit Holds Testimony from Other Trust Scheme Participants Is Inadmissible

In *United States v. Delfino*, 510 F.3d 468 (4th Cir. 2007), James and Jeaniene Delfino (the "Delfinos") appealed their convictions for tax evasion, mail fraud and conspiracy, arising from their participation in an abusive trust scheme. The Fourth Circuit affirmed the convictions, holding that the district court had properly excluded the testimony of participants in similar trust schemes because the testimony was not directly relevant to the defendants' good-faith reliance defense.

From 1993 through 2004, the Delfinos placed the income generated from their computer consulting businesses in several trusts. Neither the Delfinos nor their trusts filed income tax returns for this period.

At trial, the Delfinos asserted a "good faith" reliance defense based on advice they received from a trust promoter. They proffered testimony from six of the promoter's other clients who participated in trust schemes similar to theirs. The district court excluded those witnesses' testimony on the grounds that (1) good-faith reliance is a purely subjective defense and that the testimony of other participants was irrelevant to the Delfinos' subjective good-faith beliefs; and (2) the testimony would confuse the jury and waste time by requiring a detailed discussion of each witness's participation

in the schemes.

On appeal, the Fourth Circuit held that the district court had acted within its discretion in excluding the testimony of other participants. The circuit court noted that the proffered witnesses were not parties to the same presentations as the Delfinos, and the Delfinos had no contemporaneous knowledge that the other participants had acted on the same promoter's advice. Therefore, the court held that the proffered testimony was not directly relevant to the promoter's provision of advice to the Delfinos and their reliance thereon.

JURY INSTRUCTIONS

Third Circuit Holds Jury Instructions Constructively Amended Indictment

In *United States v. McKee*, 506 F.3d 225 (3d Cir. 2007), the Third Circuit vacated the defendants' convictions for employment tax evasion on the ground that the district court's jury instructions constructively amended the indictment by impermissibly broadening the bases for conviction.

The defendants were members of a small religious sect that opposed the payment of taxes. They jointly owned and operated a construction company that failed to withhold or pay employment taxes on their behalf. At trial, they were convicted of conspiracy to defraud the United States, employment tax evasion, and failure to file personal income tax returns.

In instructing the jury as to the types of conduct that could establish the charged employment tax evasion, the trial court had included (1) falsifying books and records to conceal the payment of wages and employment taxes due thereon; and (2) failing to report wage information to the company's accountant. These affirmative acts were never charged in the indictment, although the government had introduced evidence at trial to support them.

On appeal, the defendants argued that the jury instructions on the employment tax evasion counts were erroneous because they constructively amended the indictment.

The Third Circuit agreed, holding that the jury instructions had constructively amended the indictment and thus violated the defendants' Fifth Amendment right to due process by broadening the possible bases of conviction to include conduct not originally charged. As a result, the instructions gave rise to a presumption of prejudice against the defendant that the government had not rebutted. Therefore, the court vacated the defendants' convictions on the employment tax evasion counts and remanded for further proceedings on those counts.

SENTENCING

Fourth Circuit Holds Defendants Not Entitled to Unclaimed Deductions in Calculating “Tax Loss” for Sentencing Purposes

In *United States v. Delfino*, 510 F.3d 468 (4th Cir. 2007) (discussed above with respect to another issue), the Delfinos appealed their sentences for tax evasion, mail fraud and conspiracy, arising from their participation in an abusive trust scheme. The Fourth Circuit upheld the sentences, holding that the Delfinos were not entitled to the benefit of deductions they might have claimed but did not.

The Delfinos failed to file individual income tax returns and trust returns from 1993 through 2004. The IRS used bank records to calculate their income for this period and assessed tax without allowing any deductions the Delfinos could have claimed had they filed their returns. Following the Delfinos’ conviction, the district court determined their sentences based on the IRS calculation of the tax loss.

On appeal, the Delfinos cited *United States v. Schmidt*, 935 F.2d 1440 (4th Cir. 1991), for the proposition that, for sentencing purposes, “tax loss” means “actual loss.” On that basis, the Delfinos challenged the district court’s tax loss calculation, arguing that the court had improperly failed to subtract the deductions they could have claimed.

The Fourth Circuit held that *Schmidt* was no longer binding because the sentencing guidelines had been amended after *Schmidt* to define “tax loss” as the total amount of the loss that was “the object of the offense.” The court explained that “the object of the offense” did not mean the actual loss, but rather “the loss that would have resulted had a defendant been successful in his scheme to evade payment of tax.” 510 F.3d at 472. In this case, the court reasoned that the applicable loss was the tax on the amount by which the Delfinos underreported (or failed to report) their taxable income. The court concluded that the district court had properly used this amount to calculate the Delfinos’ sentences.

Further, the circuit court held that the district court was not required to give the Delfinos a second opportunity to claim deductions after having been convicted of tax fraud. Accordingly, the Fourth Circuit affirmed the Delfinos’ sentences.

State Tax Losses May Be Included in Calculation of Federal Sentence for Tax Evasion

In *United States v. Maken*, 510 F.3d 654 (6th Cir. 2007), the Sixth Circuit affirmed the sentence imposed on Walter Maken (“Maken”) for income tax evasion and failure to file income

tax returns, on the ground that the district court had properly included state tax losses in its calculation of Maken’s sentence.

Maken had failed to file federal and state income tax returns since 1993, despite his receipt of taxable compensation income from several sources. He was convicted of willful failure to file an income tax return, in violation of 26 U.S.C. § 7203, and tax evasion, in violation of 26 U.S.C. § 7201. In calculating Maken’s sentence, the district court included state tax losses for purposes of determining the base offense level under the sentencing guidelines. On appeal, the circuit court noted that, under the guidelines, the base offense level is determined on the basis of all acts and omissions that were part of the same course of conduct or common scheme or plan. The court reasoned that Maken’s state and federal tax offenses could be categorized both as a common scheme or plan and as the same course of conduct because they had the same “modus operandi” (*i.e.*, the refusal to file and pay taxes), and because of their “temporal proximity, similarity, and regularity.” In addition, the court noted that the Sixth Circuit as well as several other circuits had previously held that state tax offenses could constitute “relevant conduct” for purposes of sentencing.

The court concluded that the district court did not err in its determination that the state tax losses caused by Maken constituted “relevant conduct” and were therefore part of the same course of conduct for sentencing purposes. Accordingly, it affirmed the sentence imposed by the district court.

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